CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

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Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Larry D. Lisenbee

SUBJECT: **2009-2013 PRELIMINARY GENERAL FUND FORECAST**

DATE: November 7, 2007

Approved | Date 11/14/07

INFORMATION ONLY

EXECUTIVE SUMMARY

The City Manager's Budget Office has completed a preliminary 2009-2013 General Fund Forecast that will be used as an initial planning tool in the development of the 2008-2009 Proposed Budget. Following are the major highlights of the preliminary Forecast:

- A deficit of $24.8 million is projected for 2008-2009, which is slightly below the $25.5 million projected for 2008-2009 in the last five-year forecast. This updated deficit figure represents just under 3% of the projected expenditures for next year.
- The second year of the Forecast (2009-2010) has a sizeable deficit of $41.8 million. This compares with the projection of $34.3 million deficit for that year in the last forecast. The majority of this shortfall still reflects the scheduled sunsetting of the Emergency Communication System Support (ECSS) Fee as well as the impact of a number of capital projects with sizeable operating and maintenance costs that are scheduled to come on line in that year. The variances in the last three years are minimal, ranging from a deficit of $6.4 million to a surplus of $3.2 million in the last year of the Forecast.
- In the first couple years of the Forecast, the deficits are significantly larger as expenditure growth continues to outpace revenue growth. The major factors impacting performance during this period include: the sunsetting of the ECSS Fee; the two-year phase-out of the Enterprise In-Lieu and Municipal Water Rate of Return payments; the additional operating and maintenance costs associated with new facilities; and the expectation that growth in personal services costs will continue to outpace revenue growth. The economic performance is also expected to be weaker in the early years of the Forecast as the result of the impacts associated with the slowdown in the real estate market and the lingering impacts of the sub-prime mortgage problems.
- This preliminary Forecast does not include funding for the long-term liability associated with post-employment benefits that are provided by the City, deferred/unfunded infrastructure needs, impacts associated with the planned annexations from the County and the expansion of North San José, and the potential impact on City revenues and expenditures if the San José Redevelopment Agency reaches its tax increment revenue cap and is unable to continue to fund various eligible City support services. It also does not factor in one-time revenue sources, such as the 2008-2009 Future Deficit Reserve, or one-time expenditure needs.
- The preliminary Forecast will be refined over the next few months as additional information becomes available. The final 2009-2013 General Fund Five-Year Forecast will be issued in February 2008.

BACKGROUND

The City Manager's Budget Office has completed its early projections on the status of the General Fund for the next five years. This preliminary forecast will provide a starting point in the initial planning for the development of the 2008-2009 Proposed Budget and will also provide updated shortfall information for use by the City Manager's General Fund Structural Deficit Task Force and the Mayor's Budget Shortfall Advisory Group in their work to develop strategies to eliminate the General Fund structural deficit within three years. The final 2009-2013 General Fund Five-Year Forecast is scheduled to be released in February 2008.

The revenue and expenditure estimates update the figures that were last presented in the 2008-2012 General Fund Five-Year Forecast issued in February 2007. The projections reflect actual 2006-2007 revenue and expenditure performance, year-end revenue and expenditure projections based on activity through the first quarter of 2007-2008, updated revenue growth assumptions, updated salary, benefit and other cost information, and the operating impact of capital projects that are scheduled to come on line over the next five years.

ANALYSIS

Overview

The following table displays the projected General Fund incremental shortfalls or surpluses over the next five years compared to the shortfall/surplus figures presented in the February 2007 Forecast. The incremental shortfall concept (shortfall calculated by assuming each preceding deficit is solved completely with ongoing solutions in the year it appears) is used to identify the additional shortfall and/or surplus attributed to a particular fiscal year. This approach is consistent with the City's goal to solve each deficit with ongoing solutions so that each year would start with no ongoing shortfall associated with the prior year.

2009-2013 PRELIMINARY GENERAL FUND FORECAST
INCREMENTAL SURPLUSES/(SHORTFALLS)
($ in Millions)

	2008-2009	2009-2010*	2010-2011	2011-2012	2012-2013
November 2007 Incremental Surplus/(Shortfall)	**($24.8)**	**($41.8)**	**($2.4)**	**($6.4)**	**$3.2**
February 2007 Incremental Surplus/(Shortfall)	($25.5)	($34.3)	($3.6)	($7.8)	N/A

* Reflects the assumed reduction of $23.4 million due to the sunsetting of the Emergency Communication System Support Fee

The 2009-2013 fiscal outlook for the City's General Fund projected in this preliminary Forecast is fairly consistent with the February 2007 Forecast. The 2008-2009 deficit of $24.8 million is only slightly lower than the $25.5 million shortfall projected for 2008-2009 in the last forecast. This minor improvement is the net result of a number of upward and downward adjustments to the City's many General Fund revenue and expenditure categories. Several of the revenue estimates are slightly higher based primarily on final 2006-2007 performance. The fund balance projection is considerably higher based on a review of the amount of excess revenue and expenditure savings generated in recent years. These positive adjustments were almost entirely offset by various negative adjustments. These include lost revenue from a presumed two-year phase-out of the Enterprise In-Lieu and Municipal Water Rate of Return payments, salary and benefit changes associated with the recent Fire arbitration award, and various other expenditure adjustments.

In the out-years of the Forecast, the incremental variances between revenues and expenditures range from a deficit of $41.8 million in 2009-2010 to a small surplus of $3.2 million in 2012-2013. The large deficit in 2009-2010, which exceeds the $34.3 million presented in the February 2007 Forecast, primarily reflects the presumed loss of $23.4 million in revenue due to the scheduled sunsetting of the Emergency Communication System Support Fee and the additional cost associated with operating new facilities, exacerbated by a reduced rate of growth in several key revenue categories resulting from the deteriorating real estate market. In the last three years of the Forecast, the incremental shortfalls or surpluses are relatively small with annual differences ranging from a deficit of $6.4 million to a surplus of $3.2 million, which represent less than 1% of the annual projected expenditures of approximately $1 billion.

Major Forecast Components

The three major components of the General Fund Forecast include the following: 1) revenue projections; 2) projections on the cost of delivering existing services; and 3) projections on the cost of delivering additional services to which the City is currently committed, primarily the operating costs of new facilities scheduled to come on line in the next few years. Following is a discussion of each of those components.

General Fund Revenues

The General Fund revenue estimates for the first year of the Forecast have been prepared by analyzing over 500 individual revenue accounts. This includes reviewing actual collection trends, developing revenue growth assumptions based on current economic conditions, evaluating any available information on future rate increases/activity trends that would impact the City's revenues, and updating reimbursement-related revenues based on projected costs. Approximately one-half of the General Fund revenues are generated from categories that are tied directly to the performance of the economy, including the City's two largest revenue sources, Property Tax and Sales Tax. The remaining categories, while impacted by overall economic performance, are driven by other factors, such as rate changes and reimbursement-related costs. For the out-years of the Forecast, growth assumptions for the economically sensitive revenue categories were developed by the City's economic forecasting consultant.

For this preliminary Forecast, it is assumed that the national and California economies will experience slower than previously anticipated growth, but will not sink into an actual recession as a result of the continued impact of the housing market slowdown and the lingering impacts of the sub-prime mortgage problems. In the out-years of the forecast, economic growth is expected to improve somewhat as the housing market begins to recover from the current slowdown.

Underlying General Fund revenue growth in the range of 3% to 4% is expected annually over the Forecast period, with lower growth in the earlier years that picks up somewhat in the out-years. As previously noted, a significant downward adjustment has been presumed in 2009-2010 to reflect the scheduled sunsetting of the Emergency Communication System Support Fee.

In addition to forecasting the General Fund revenues, an estimate is developed for the Beginning Fund Balance that would be generated from the prior year excess revenue collections and expenditure savings. These funds are included as a funding source in the Forecast. Based on a review of recent performance, the methodology for projecting the available Beginning Fund Balance has been adjusted. Previously, the forecasts have presumed an annual flat amount, which totaled $20 million in the February 2007 Forecast. This Forecast has been revised to utilize a formula that assumes that a percentage of excess revenues and expenditure savings will be generated each year. In 2008-2009, this calculation would generate approximately $25 million of Beginning Fund Balance that has been incorporated into the Forecast.

General Fund Expenditures

To estimate the General Fund expenditures, growth assumptions are developed for each of the General Fund expenditure categories, including Personal Services, Non-Personal/Equipment, City-Wide Expenses, Capital, Reserves, and Transfers. The largest cost category is Personal Services, which represents over two-thirds of the City's base costs. Personal Services costs are broken down into three major components: Salaries and Other Compensation, Retirement, and Health and Other Fringe Benefits. The first year (2008-2009) projection for Personal Services costs has been calculated at a detailed level by analyzing each of these cost components. The projections for the remaining years of the Forecast are developed by applying growth assumptions to the Personal Services components. The Personal Services budget for each department is also adjusted to reflect anticipated vacancies during the year.

To develop the 2008-2009 Personal Services projections, an extract of payroll system information as of August 2007 was used as the starting point to identify the salaries, current salary steps, and benefits of existing staff. Salaries and Other Compensation and Retirement costs are adjusted for scheduled step increases, anticipated salary cost-of-living adjustments (COLAs) that are subject to negotiation, and any other salary-related adjustments. The Forecast also assumes annual step increases for employees that have not reached the top step in their classification. The projected average growth rate associated with step increases alone is estimated at approximately 1.4% annually in this Forecast. This accounts for approximately $8.5 million of the Personal Services costs in 2008-2009.

Retirement costs are calculated as a percentage of salary costs. In this Forecast, retirement costs have only been adjusted for the impact of step increases and COLAs. It should be noted that every two years, an actuarial study is completed on the City's two retirement systems, Federated and Police and Fire. Actuarial studies are now in process and revised retirement contribution rate recommendations for 2008-2009 and 2009-2010 are expected to be brought forward for consideration by both boards in time for inclusion in the February 2008 Forecast. Due to the volatility of retirement rates, however, no predictions for the retirement rate contribution adjustments that will be made have been assumed in this preliminary Forecast.

Health and Other Fringe Benefit cost increases have been projected in each year of the Forecast. Based on preliminary discussions with the Human Resources Department, a 15% increase to the City's contribution for employee health care has been assumed for 2008-2009, with 10% increases assumed in each of the out years of the Forecast. The value of this increase in 2008-2009 is $3.1 million. In the Other Fringe Benefits category (dental, unemployment insurance, employee assistance program), annual increases of 5% are assumed in all forecast years. The value of that increase is $700,000 in 2008-2009.

In addition to evaluating the individual Personal Services cost components, a review of the overall vacancy rates for each City department was conducted to determine if adjustments to the departmental vacancy factors are warranted. The Personal Services budget for almost every City department is adjusted downward slightly to reflect vacancy factors that typically range from 0% to 4%. In this Forecast, the vacancy factors for a number of departments were increased slightly based on actual activity in recent years. Those adjustments saved just under $1 million in 2008-2009.

This preliminary Forecast also incorporates Personal Services adjustments to reflect prior City Council direction. For instance, the Personal Services costs in 2010-2011 have been reduced to reflect the end of the three-year funding strategy for Enhanced Parks Maintenance that was approved in the 2007-2008 Adopted Budget. Similarly, the Personal Services costs have also been adjusted to ensure that the development fee programs in the Fire, Public Works, and Planning, Building and Code Enforcement Departments have a neutral impact on the City's General Fund Forecast as these programs are designed to recover 100% of their costs. Because costs in these fee programs are currently anticipated to exceed revenues by $5.1 million in 2008-2009, the costs have been reduced by that amount in this Forecast. Each of the fee programs will be required to develop strategies that will address this $5.1 million shortfall in the 2008-2009 Proposed Operating Budget process. These strategies will likely include a combination of fee increases, expenditure reductions, and the use of portions of the Development Fee Program Reserves.

On an overall basis, Personal Services costs in the 2009-2013 Five-Year Forecast are projected to increase approximately 4.4% annually. This average annual growth figure factors in projected cost-of-living adjustments, step increases, benefit changes, and adjustments to vacancy factors discussed above. It is anticipated that this growth figure will be revised in the final 2009-2013 Forecast to reflect the updated retirement rates and any additional updates to benefit costs.

The remaining cost categories, Non-Personal/Equipment and Other Expenditures (City-Wide, Transfers, Capital, Contingency Reserve and Earmarked Reserves) have also been calculated at a detailed level for the first year of the Forecast. The process utilized by the Budget Office included eliminating one-time allocations that were approved in 2007-2008, annualizing all partial-year reductions or additions approved in 2007-2008, and incorporating adjustments for specific large Non-Personal/Equipment allocations (e.g., utilities, leases, contracted services and Police Department vehicle replacement). The Forecast also reflects adjustments to vehicle maintenance and operating costs, debt service payment obligations, and contractually required cost-of-living increases to major contracts. In all five years of the Forecast, the Contingency

Reserve category has been adjusted in order to maintain the City Council policy of maintaining a Contingency Reserve equal to 3% of eligible expenditures.

For the out-years of the Forecast, an annual growth rate of 2.0% has been assumed for the Non-Personal/Equipment costs. In the Other Expenditures category, every line item has been calculated for each of the out-years based on the specific drivers for that line item. For instance, debt service payments are based on the projected debt service schedules.

General Fund Committed Additions

As has been the City's practice with the General Fund forecasts, cost estimates for a number of specific Committed Additions that address previous City Council direction are included in this preliminary Forecast in the years that they are projected to be required. The Committed Additions category primarily reflects projected maintenance and operating costs for new capital projects now in the Adopted Capital Improvement Program, including bond-financed libraries, community centers, parks and public safety facilities. Some of the larger facilities expected to come on line during this forecast period include the South San José Police Substation; Bascom, Solari, Roosevelt, and Mayfair Community Centers; and the Bascom and Southeast Branch Libraries. In the first year of the forecast period, Committed Additions are projected at $4.8 million. This represents approximately 20% of the net overall General Fund shortfall of $24.8 million projected in 2008-2009. In 2009-2010, an additional $7.6 million in Committed Additions are included, which accounts for approximately 18% of the General Fund deficit in that year. In the last three years of the Forecast, the Committed Additions drop to $3 million in 2010-2011, $1.5 million in 2011-2012, and $0.6 million in 2012-1013. The General Fund deficits also taper off in these last three years with a small surplus actually projected in 2012-2013.

Several new Committed Additions have been added when compared to the forecast released in February 2007. These include critical investments to replace cardiac monitors and defibrillators based on the product life-cycle, maintain transportation infrastructure from planned County annexations, and retrofit the existing fleet of diesel powered vehicles based on State-mandated regulations.

Impact of Bond-Financed Committed Additions

The operating and maintenance costs of bond-financed capital projects account for the majority of the Committed Additions. During the October 25, 2007 City Council Study Session on Deferred Maintenance and Infrastructure Backlog, Mayor Reed requested information concerning the impact that ongoing operations and maintenance from bond-financed facilities (Library, Parks, and Public Safety) would have on the General Fund surplus/shortfall.

The following table depicts the impact of bond-financed facilities on the incremental budget surplus/shortfall.

IMPACT OF BOND-FINANCED FACILITIES OPERATIONS AND MAINTENANCE COSTS ON GENERAL FUND SURPLUS/SHORTFALL ($ in Millions)

	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013
2009-2013 Preliminary Forecast Incremental Surplus/(Shortfall)	**($ 24.8)**	**($ 41.8)**	**($ 2.4)**	**($ 6.4)**	**$ 3.2**
Incremental Bond-Financed Facilities O & M Costs	($ 3.8)	($ 4.6)	($ 4.1)	($ 1.3)	($ 0.6)
Incremental Surplus/(Shortfall) Less Bond-Financed Facilities O & M	($ 21.0)	($ 37.2)	$ 1.7	($ 5.1)	$ 3.8
% of Deficit Attributed to O & M Costs of Bond-Financed Facilities	15.3%	11.0%	100%	20.3%	N/A

As shown in this table, the incremental operations and maintenance costs of the bond-financed facilities are larger in the first three years of the Forecast ($3.8 million to $4.6 million) as the majority of the bond projects come on line and drop off to $0.6 million by 2012-2013. These costs as a percentage of the overall deficit range from 11% to 100%. In 2010-2011, the removal of these costs from the incremental shortfall of $2.4 million would result in a surplus in that year of $1.7 million. It should be noted, however, that the operations and maintenance costs are necessary in order to appropriately staff and maintain the new facilities. If no additional funding is available, cuts in other areas would be necessary to support these new facilities.

Major Drivers of the General Fund Structural Deficit

In the preliminary 2009-2013 General Fund Forecast, the incremental deficits in the first two years ($24.8 million and $41.8 million) are significantly larger than the deficits and surpluses in the remaining three years that range from a deficit of $6.4 million annually to a surplus of $3.2 million. The incremental shortfalls and surpluses in the last three years are minimal and represent less than 1% of the projected expenditure level. With these projected trends, it is important to understand the drivers for the larger deficits in the early years of the Forecast.

Following is a brief description of the major drivers for the General Fund deficits in the first two years of the Forecast.

- The Emergency Communication System Support Fee is scheduled to sunset after 2008-2009, which results in a $23.4 million reduction in General Fund revenue.
- The Enterprise In-Lieu and Municipal Water Rate of Return payments are assumed to be phased out over a two-year period in 2008-2009 and 2009-2010, which results in a loss of over $5 million annually at the end of the phase-out period.
- Expenditure growth continues to outpace General Fund revenue growth. Personal Services costs (salaries, retirement, and associated fringe benefits), which represent the largest cost component for the General Fund, are expected to increase approximately 4.4% annually. Revenue growth, however, is expected to range from virtually no growth in 2009-2010 (due primarily to the sunsetting of the ECSS Fee) to 4% growth in 2012-2013. Slightly lower

revenue growth in some of the economically sensitive revenue categories is also expected in the first two years of the Forecast due to the current economic conditions.

- As discussed above, the majority of the additional costs associated with new facilities coming on line is realized in the first couple of years of the Forecast, with minimal incremental costs experienced by the fifth year of the Forecast.

Revenues/Expenditures Not Reflected in Forecast Model

It should be noted that there are a number of unfunded expenditure items that are expected to impact the City's General Fund condition in the five-year period that are not fully reflected in this forecast model. These include the impacts associated with any additional funding provided for unfunded infrastructure needs, the long-term liability associated with post-employment benefits that are provided by the City, expenditure categories the City Council may want to consider augmenting due to the planned annexations from the County, the impact on revenues and expenditures that may develop from the expansion of North San José, and the potential impact on City revenues and expenditures if the San José Redevelopment Agency reaches its tax increment revenue cap and is unable to continue to fund various eligible City support services.

As presented to the City Council previously, the estimated unfunded retiree healthcare liability for the City of San José is currently estimated to be well over $1 billion based on recent actuarial analyses. The Governmental Accounting Standards Board (GASB) Statements 43 and 45 now require public agencies to report the long-term liability for retiree health care and to record any portion of annual contributions that are not funded. A Retiree Health Care Team has been established to work with various stakeholder groups to develop potential strategies to address this liability.

The City's deferred maintenance and unfunded infrastructure backlog are also not reflected in this preliminary Forecast. As discussed in the recent City Council Study Session on the Deferred Maintenance and Infrastructure Backlog, one-time needs approximating $915 million and ongoing needs upwards of $45 million were identified. In conjunction with the City Manager's General Fund Structural Deficit Task Force, staff will analyze the impact of these costs on the General Fund, and bring forward various new funding proposals to begin to address this need.

At this point, no revenue adjustments and minimal expenditure adjustments have been made to reflect the impact of annexations and the significant expansion associated with North San José. After additional analysis is completed, the projected revenue and expenditure impacts of these changes will be incorporated into the 2008-2009 budget process, through the final 2009-2013 General Fund Forecast and/or through the 2008-2009 Proposed Budget. In addition, if the San José Redevelopment Agency is no longer able to fund eligible City support services, the revenues and expenditures associated with these activities will be adjusted downward. Because it is unlikely that the City will be able to reduce all expenditures reimbursed by the Agency, such as funding for a portion of the Mayor and City Council and the Office of Economic Development, there could potentially be a net loss of approximately $6 million starting in 2009-2010. The Administration plans to present the impact of the potential loss of Agency funding in one of the alternative forecast scenarios that will be brought forward as part of the final 2009-2013 General Fund Forecast in February 2008.

Because the Forecast compares ongoing revenues and expenditures, it does not factor in one-time funding sources, such as the 2008-2009 Future Deficit Reserve or one-time expenditure needs. These one-time sources and potential obligations will be identified in the final 2009-2013 General Fund Forecast but will not be included in the deficit/surplus figures.

NEXT STEPS

The next steps in the budget development process include the following:

November/December 2007

- City Manager's General Fund Structural Deficit Task Force – support the Mayor's Budget Shortfall Advisory Group in the development of strategies to address the City's General Fund Structural Deficit within three years.
- Development of 2008-2009 General Fund reduction targets for all City Service Areas.

January 2008

- City Manager's General Fund Structural Deficit Task Force – release report on strategies to address the General Fund Structural Deficit within three years.
- Community Budget Survey.
- Neighborhood Association/Youth Commission Priority Setting Session.

February 2008

- Mayor's Budget Shortfall Advisory Group – release three-year strategic plan for addressing the City's General Fund structural deficit for City Council consideration.
- 2008-2009 City Manager's Budget Request and 2009-2013 Five-Year Forecast and Revenue Projections for the General Fund and Capital Improvement Program released.

March 2008

- 2008-2009 Mayor's March Budget Message released with public hearing and amendments/ approval by City Council.

April 2008

- 2008-2009 Proposed Capital Budget and 2009-2013 Capital Improvement Program released.

May 2008

- 2008-2009 Proposed Operating Budget and 2008-2009 Proposed Fees and Charges released.
- City Council Study Sessions and initial Public Hearing on 2008-2009 Proposed Operating Budget, 2008-2009 Proposed Capital Budget and 2009-2013 Capital Improvement Program, and 2008-2009 Proposed Fees and Charges.

June 2008

- 2008-2009 Mayor's June Budget Message released with public hearing and amendments/ approval by City Council.
- 2008-2009 Operating Budget, 2008-2009 Capital Budget and 2009-2013 Capital Improvement Program, and 2008-2009 Fees and Charges – City Council adoption.

CONCLUSION

This preliminary 2009-2013 General Fund Forecast is intended to serve as a starting point in the development of the 2008-2009 Proposed Budget. The 2008-2009 General Fund deficit is currently estimated at $24.8 million, which reflects only a slight improvement from the February 2007 Forecast. This deficit figure represents approximately 2.8% of the projected General Fund expenditures for 2008-2009.

It is important to note that the preliminary Forecast is based on relatively little data and will be refined over the next few months as additional information becomes available. The final 2009-2013 General Fund Five-Year Forecast is scheduled to be released in February 2008. This later and updated Forecast will take into account more data regarding economic trends, which will allow a more informed analysis of the General Fund revenues. The expenditure estimates will also be updated with any additional information on expected retirement contribution rates and other benefit rates. The February 2008 Forecast will also include additional scenarios that will illustrate the impacts of lower or higher revenue and expenditure growth on the City's General Fund.

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